CIBC GLOBAL ASSET MANAGEMENT

Steady hands amid shifting currents

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Bond market commentary: Q2 review and Q3 2026 outlook

The second quarter of 2026 saw the bond market contend with a complex mix of geopolitical risk, shifting inflation dynamics, and evolving central bank policy. The most significant event was the closure and subsequent reopening of the Strait of Hormuz. The initial supply shock from the Middle East conflict drove oil and gasoline prices sharply higher, which in turn pushed headline inflation readings above expectations in both the US and Canada. As the quarter progressed, a rapid de-escalation and a tentative agreement to reopen the Strait led to a reversal in West Texas Intermediate (WTI) oil prices, which fell to approximately $70/bbl by late June. This sequence of events had a direct impact on bond yields and credit spreads.

US GDP for Q1 was revised up to 2.1% annualized, and Canadian employment posted modest gains. Inflation remained a key concern, with US headline CPI rising to 4.2% year-over-year in May and Canadian CPI at 3.2%, both above central bank targets. However, core inflation measures were comparatively stable, with much of the headline surprise driven by energy.

In the US, the Federal Reserve, now chaired by Kevin Warsh, pivoted to a more market-driven communication strategy, removing explicit forward guidance and emphasizing a data-dependent approach. The June FOMC meeting was notably hawkish, with the dot plot indicating no rate cuts for 2026. This led to a repricing of the front end of the curve, as 2-year Treasury yields rose, closing the quarter at 4.14%. The 10-year yield remained anchored near 4.45%, while the 30-year rallied modestly as duration buyers stepped in. The result was a bear-flattening of the US yield curve, with the 2s30s spread compressing following the meeting.

CIBC Global Asset Management's portfolios entered the quarter anticipating too many cuts were priced into the market, and appropriately positioned for the flattening yield curve.

The Bank of Canada maintained its overnight rate at 2.25%, emphasizing patience as it monitored the impact of higher energy prices and a mixed domestic growth outlook. The Canadian yield curve tracked the US, with short-term yields rising more than long-term yields.

Credit markets remained resilient through much of the quarter. The initial widening of spreads following the Middle East escalation was quickly retraced as risk appetite returned. Canadian investment-grade spreads averaged around 85 basis points, and US high yield spreads hovered near 265 basis points. Notably, the primary market was robust, with strong demand for new supply across both public and private markets. Amazon's $14 billion Canadian bond and Google's $8.5 billion issue set new records, while private credit markets arranged $35 billion in financing for AI infrastructure.

Credit exposure was managed conservatively, with the lowest active overweight in years heading into the Middle East conflict. The focus was on high-quality investment-grade issuers and shorter tenors. Where permitted, credit protection was added to further reduce risk. As volatility led to wider credit spreads, the team selectively increased credit exposure where valuations became compelling, but remained focused on quality and liquidity rather than chasing yield. Sector selection favored issuers with strong pricing power (particularly in energy, banking, and infrastructure) as well as businesses with durable, government-linked revenues, including segments of the AI buildout. The emphasis was on active management, security selection, and portfolio precision.

In terms of performance, the FTSE Canada Universe Bond Index and FTSE Canada All Corporate Bond Index returned 2.24% and 2.23% respectively during the year. These results reflect a market that experienced both upward pressure on yields during the early stages of the quarter and a recovery as geopolitical risk subsided and oil prices softened.

Outlook for the second half of 2026

Looking ahead, CIBC Global Asset Management expects both the Federal Reserve and Bank of Canada to remain on hold for the remainder of 2026, with risks skewed toward a longer pause rather than renewed tightening. The Fed's new approach under Warsh (eschewing forward guidance) places greater emphasis on realized inflation and employment data. Unless there is a renewed, broad-based acceleration in core inflation or a sharp unanchoring of inflation expectations, the bar for additional rate hikes remains high.

The Bank of Canada faces a more rate-sensitive economy due to high household leverage and frequent mortgage resets. This accelerates the transmission of policy into the real economy and raises the hurdle for further tightening, especially as growth risks persist from trade uncertainty and a softening real estate sector.

The principal risk to this outlook remains energy prices and the potential for renewed supply shocks. However, the recent episode demonstrated that the bond market is better insulated from geopolitical turmoil than in 2022: starting yields are materially higher, and much of the inflation risk is already priced into short-term rates. Should stagflationary conditions emerge, today's higher yields provide a more robust cushion for fixed income portfolios than was the case in the low-yield environment of previous years.

From a portfolio construction perspective, the most attractive opportunities remain in the intermediate part of the curve (3–7 years). This segment offers a combination of elevated all-in yields and manageable interest-rate risk. Should yields overshoot on renewed inflation fears or a temporary repricing of central bank expectations, the team is prepared to extend duration, as a subsequent growth scare would likely drive yields back lower.

Credit selection will continue to emphasize quality, shorter maturities, and sectors with strong pricing power, while maintaining flexibility to add risk if spreads widen. High-quality hybrid securities and businesses with stable, government-tied revenues remain favored. The current environment demonstrates the restored traditional role of bonds as income generators and portfolio stabilizers, a marked contrast to the 2022 experience.

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[1] CIBC Global Asset Management (previously known as TAL Global Asset Management Inc.) was founded in 1972 as a privately-owned investment manager. CIBC took an ownership stake in 1994, eventually assuming 100% in 2001.

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